In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 849

ROBERT I. INGALLS, JR. AND MRS. JANE S. INGALLS, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW AND JURISDICTION

The opinions below and the basis for this Court's jurisdiction are adequately described in the petition.

QUESTION PRESENTED

Whether petitioner's [1] indebtedness of $228,360 to the Ingalls Iron Works Company was discharged in

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[1] "Petitioner" refers to Robert Ingalls, Jr. Jane Ingalls, his wife, is a party because a joint tax return was filed.

1961, so that the entire amount is includible in his gross income for that year?

STATUTE INVOLVED

Internal Revenue Code of 1954:

> SEC. 61. GROSS INCOME DEFINED.
>
> (a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
>
> * * * *
>
> (12) Income from discharge of indebtedness;
>
> * * * *
>
> (26 U.S.C. 1964 ed., Sec. 61)

STATEMENT

The issue here arises out of the determination of the Commissioner of Internal Revenue that petitioner realized income in the amount of $228,360 in 1961 when the Ingalls Iron Works Company effectively cancelled petitioner's debt to the company in that amount in return for petitioner's renunciation of his rights under a long-term employment contract with the company.

Amounts petitioner borrowed from the company between 1953 and 1958 were reflected in a note executed on September 24, 1958, for $258,664. By January 1961, payments had reduced the principal amount of the note to $228,360. In March 1959, petitioner and the company had agreed that he would be

general manager for a period of 15 years at an annual salary of $100,000. An intra-family dispute extending over many years culminated in petitioner's elimination from all involvement with the company. During negotiations leading up to the final settlement on January 30, 1961, the company contended that petitioner owed the company more than the principal amount of the 1958 note and that the 1959 employment contract was invalid (Pet. 43-44.)

As part of the settlement, petitioner and the company agreed that he owed the company the principal amount outstanding on the note—i.e., $228,360—and that the company would pay him the same amount—i.e., $228,360—in return for a renunciation of his rights under the 1959 employment contract. This agreement was formalized in two contemporaneous documents, a termination agreement and a new note. In the former, the company agreed to pay petitioner $228,360 for his interest in the employment contract, in equal installments of $22,836, payable on February 1 of the ten next succeeding years. Petitioner in turn executed a new note for $228,360, payable in ten installments of $22,836, also on February 1 of the next ten years. In addition, the termination agreement provided that (Pet. 45) "so long as any part of said indebtedness [of petitioner] or any interest thereon remains unpaid, the company may make the payments hereinabove agreed to be paid to him by currently crediting said indebtedness with such payments as they accrue." The company accepted petitioner's new note, which was unsecured and bore no interest, in lieu of the 1958 note which was secured by insurance poli-

cies and bore annual interest of 2 percent. The insurance policies, which had been held by the company as collateral on the old note, were returned to petitioner (Pet. 44-45). Beginning on February 1, 1962, petitioner and the company exchanged checks for $22,836 and followed that course on each February 1 thereafter up to the date of trial (Pet. 44-45).

For each year up to trial, petitioner reported as income the $22,836 paid to him by the company on February 1 of that year. The Commissioner of Internal Revenue determined that the settlement of January 30, 1961 effected an immediate, full cancellation of petitioner's debt to the company in the amount of $228,360, resulting in gross income in that amount for 1961. (Pet. 33.) The district court agreed with petitioner that the amount could be reported as income in ten installments, consistently with the parties' exchange of checks each February 1. (Pet. 34-39.) The court of appeals reversed, holding that there was an immediate cancellation of petitioner's $228,360 debt as of January 30, 1961 (Pet. 46-49).

ARGUMENT

The decision below is correct. It is not in conflict with any other court of appeals decision and presents no issue which otherwise warrants review.

1. The court of appeals correctly held that the practical effect of the agreement entered into on January 30, 1961 by petitioner and the company was to absolve petitioner thereafter from making payments on his personal debt to the company. Thus the company's forgiveness of the debt, in return for petitioner' re-

nunciation of his employment contract, resulted in gross income to petitioner in the amount of the debt in 1961, the year in which the agreement was executed. Section 61(a)(12), Internal Revenue Code of 1954 (p. 2, *supra*). Petitioner and the company agreed that their mutual claims against one another were equal in amount and that one would offset the other. Solely to accommodate petitioner's desire to avoid taxation of the total amount of cancelled debt in one year, the company agreed, in effect, to record the cancellation on its books over a ten-year period and further agreed to exchange checks in identical amounts each year with petitioner.

Once the agreement was entered into, only one of two possible events would occur: either petitioner would give the company $22,836 each February 1 and the company would give it back to him, or he would not give the company $22,836 and the company would simply charge off the amount due on the note against petitioner's debt to the company. Neither event could have any economic or legal effect; after each February 1, each party would have exactly what it had before, and neither party at any time after the date of the agreement had a claim against the other which could be legitimately transferred or sued upon. (Pet. 46-47.)

As the court of appeals observed, once the agreement was entered into (Pet. 47), "the taxpayer had to perform no additional act for the debt to be discharged" so that (*id.*):

> The exchange of checks by the company and the taxpayer was thus an empty ritual acted out for

> the benefit of the Commissioner and, in reality, the taxpayer was discharged from his indebtedness on January 30, 1961.

Thus, under established tax principles set forth in Section 61(a)(12) of the Internal Revenue Code of 1954 (p. 2, *supra*), the full $228,360 was properly includible in petitioner's gross income for 1961.

2. The cases which petitioner claims to conflict with the result here involve the doctrine of "constructive receipt". (Pet. 13-27). That doctrine provides that when a taxpayer is absolutely entitled to receive funds which would constitute income if paid, inclusion of the funds in income cannot be avoided by the taxpayer's failure actually to claim the funds. Application of the doctrine typically turns on the degree to which the taxpayer was legally entitled to receive the funds in the taxable year in question. The cases cited in the petition were decided in favor of the taxpayers there involved because the particular circumstances of those cases imposed restrictions on the right to receive the funds in the years in issue. See *Richards' Estate* v. *Commissioner*, 150 F. 2d 837 (C.A. 2); *Commissioner* v. *Olmsted Incorporated Life Agency*, 304 F. 2d 16 (C.A. 8); *Kasper* v. *Banek*, 214 F. 2d 125 (C.A. 8); *Glenn* v. *Penn*, 250 F. 2d 507 (C.A. 6); *Willits* v. *Commissioner*, 50 T.C. 602. Where, however, the substance of a transaction as opposed to its form is that a taxpayer has the absolute right to receive funds, they will be taxed to him under the constructive receipt doctrine. See Regs. 1.451-2. See also *Newmark* v. *Commissioner*, 311 F. 2d 913 (C.A. 2); *Frank* v. *Commissioner*, 226 F. 2d 600 (C.A. 6); *Williams* v.

United States, 219 F. 2d 523 (C.A. 5). Thus, the cancellation of indebtedness here was properly deemed to have occurred for tax purposes when petitioner was assured that the debt no longer would have to be paid, just as in the constructive receipt area a taxpayer is deemed to have received amounts which he is assured of receiving upon his demand. There was no intent on the part of petitioner or the company that either would pay anything to the other in years after 1961 or that either would be placed at the risk of the other's nonpayment of its existing obligation after the termination of petitioner's relationship with the company. Simply put, the parties effected a "wash" of their claims against one another, effective as of January 30, 1961.

The conclusion reached by the court of appeals implements the following admonition of this Court in *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334:

> The incidence of taxation depends upon the substance of a transaction. * * * To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

The substance of the transaction was an immediate cancellation of petitioner's debt to the company which was cast, exclusively for tax purposes, in the empty form of mutual installment payments of identical amounts on identical dates over a ten-year period. The court of appeals properly gave tax effect to the substance.

CONCLUSION

For the foregoing reasons the petition for a writ of certiorari should be denied.

Respectfully submitted.

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